The PERAC Financial Bulletin

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Financial Market Review | First Quarter, 2000

For equity investors, the first quarter of the 21st century was not for the faint-of-heart. As the US economy entered the tenth year of economic expansion with no slowdown in sight and investors continued to pour money into the hottest segments of the market, most stock indices registered gains for the quarter. Nevertheless, the market exhibited gut-wrenching volatility as investor sentiment swung dramatically between the full-valued growth stocks of the "new economy" and the far more reasonable values found among the languishing stocks of the "old economy."

The Dow Jones Industrial Average, epitomizing the more traditional companies, lost 5% for the quarter while the large-cap S&P 500 rose 2%, the small stock Russell 2000 increased 6.8%, and the technology-laden NASDAQ Composite extended its astonishing performance of 1999 with a 12.4% advance. For both large, mid, and small cap indices, growth stocks continued to trounce value. (See chart) Overall, market performance continued to be concentrated in a comparatively small segment of stocks. However, after peaking in early March, growth stocks and tech stocks suffered sharp declines for the balance of the month, with the NASDAQ off 9.4% from its high even after a late month recovery from the depths of its swoon.

Stocks overall suffered from disappointing earnings reports (Procter & Gamble) and some cautionary pronouncements by formerly bullish market strategists (Goldman Sachs' Abby Joseph Cohen), but tech and growth stocks were particularly pummeled in March not only from fear of Microsoft's legal problems but also from increasing concern that valuations were simply too high and due for a major correction.

Global equity markets were basically flat for the quarter. North and South American markets had modest advances, led by Canada. Latin American markets also generally rose, European markets were off slightly, while several Asian markets gave back some of their impressive gains registered in 1999.

Although stocks have been dominant not only in the financial press but also in investors' cash commitments, the bond market also had a very interesting quarter. In its continuing effort to keep the economy from overheating and possibly to take some froth out of the stock market, the Federal Reserve tightened monetary policy for the fourth and fifth times over the past year. In spite of this, intermediate and long-term Treasury bond rates actually declined, reflecting not only investors' confidence that the Fed would be successful in restraining inflation but also, and even (CONTINUED ON PAGE 2)

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With the Dow and the S&P 500 showing stability and even strength during the NASDAQ slide, it was apparent that the market was undergoing its long-anticipated revaluation of those segments that had been driven to seemingly irrational levels.

(CONTINUED FROM PAGE 1) more importantly, the effects of the government's announcement that it would be buying back significant amounts of its outstanding bonds with money amassed from its burgeoning budgetary surpluses. The bellweather 30-year Treasury bond declined in yield from 6.48% to 5.83%, representing a total return of 9.1% for the quarter. Most other segments of the bond market enjoyed more moderate positive performance.

At quarter-end, the 30-year Treasury bond yielded 65 basis points less than the 2-year note. This unusual phenomenon, known as an "inverted yield curve", has often been seen as the precursor of a slowing economy and a possible peak in rates, but most analysts have concluded that the current inversion is of lesser significance because it has been due more to "supply and demand" imbalances than to changed economic fundamentals.

Living up to its reputation as an asset class that delivers steady, reasonable returns, real estate offered little in the way of dramatic change or surprises in the first quarter. Publicly-traded equity REITs returned 2.4% on average. After two years of negative returns, many analysts consider this sector to offer good value. When available, it's expected that performance of privately-held real estate for the quarter will remain in the 2.5-3.0% range exhibited over the past year.

Venture capital has been an asset class that continues to outshine even the equity market. Industry-wide reported returns typically lag by more than a calendar quarter, but, on the basis of media reports as well as the returns achieved by a number of Massachusetts retirement systems invested in this sector, typical returns have been extremely impressive, significantly outperforming the S&P 500. Some partnerships invested in internet ventures and other new-economy start-ups achieved returns exceeding 100% last year. In sharp contrast, partnerships focused on more traditional businesses had far more modest returns.

Pension funds, endowments, and other major investors continue to increase their allocation to private equity and many business executives from all walks of life have been giving up their secure positions in order to join the "dot-com" mania. However, as April progressed, technology stocks continued to suffer a sharp correction in the market, internet stocks have taken a particularly intense pounding as investors increasingly conclude that many of them will never achieve profitability, and the tone of the market for initial public offerings turned decidedly more cautious. If these trends continue, 1999 could well prove to be the high-water mark for venture capital returns.

By April 12, the NASDAQ composite had fallen below 3800, having given back all of its gains so far this year and falling into sharp negative territory in a startling retreat of more than 25% from its high of 5049 reached on March 10. With the Dow and the S&P 500 showing stability and even strength during the NASDAQ slide, it was apparent that the market was undergoing its long-anticipated revaluation of those segments that had been driven to seemingly irrational levels. With many internet start-ups with no profits in sight having garnered staggering market valuations, with Yahoo! and Cisco Systems trading at price-to-earnings ratios of about 1700 and 200, respectively, at the end of March while Ford Motor Company had a P/E of about 8 and the Dow Jones Industrial Average had a composite P/E in the low 20s, a rebalancing of the stock market may well have been inevitable. A significant closing of the performance gap between technology and "old economy" stocks and between growth and value stocks could well be healthy for the overall market long-term. If this is indeed the beginning of the long-feared bursting of the technology "bubble", it will bring some solace to those long-suffering traditional investors who have long waited for a reversion to more rational, historically-consistent valuations. If the new economy is indeed becoming old more quickly than anticipated, proponents of asset allocation will hail the change as a long-overdue setback to momentum investing and a vindication of the strategy of having reasonable allocations to all asset classes and subclasses. ↭

PLEASE NOTE:
The PERAC Investment Unit welcomes any comments you may have on this report & encourages all boards to contact us at any time for assistance relating to investment activities. Extra copies of this report are available.

First Quarter, 2000 | Total Returns

U.S. Equity Market

INDEX	FIRST QUARTER RETURN	12 MONTHS
DOW JONES INDUSTRIAL AVG.	- 4.68%	13.28%
STANDARD & POOR'S 500	2.29%	17.94%
NASDAQ COMPOSITE	12.37%	85.78%
WILSHIRE 5000	3.82%	23.61%
RUSSELL MIDCAP	10.08%	30.77%
RUSSELL 2000	7.08%	37.29%

Growth vs. Value

INDEX	FIRST QUARTER RETURN	12 MONTHS
S&P 500 GROWTH	4.11%	24.92%
S&P 500 VALUE	0.23%	9.86%
RUSSELL MIDCAP GROWTH	21.12%	77.20%
RUSSELL MIDCAP VALUE	1.01%	4.14%
RUSSELL 2000 GROWTH	9.28%	59.04%
RUSSELL 2000 VALUE	3.82%	13.26%

Global Equity Markets

INDEX	FIRST QUARTER RETURN	12 MONTHS
M.S.C.I. - E.A.F.E	- 0.05%	25.34%
M.S.C.I. - EMERGING MARKETS	4.93%	56.87%

Fixed Income

INDEX	FIRST QUARTER RETURN	12 MONTHS
LEHMAN BROTHERS AGGREGATE INDEX	2.21%	1.87%
LEHMAN BROTHERS GOVERNMENT/ CORPORATE INDEX	2.69%	1.70%
FIRST BOSTON HIGH-YIELD INDEX	- 1.29%	0.30%

Real Estate

INDEX	FIRST QUARTER RETURN	12 MONTHS
NAREIT - EQUITY REAL ESTATE INVESTMENT TRUSTS	2.39%	2.61%
NCREIF PROPERTY INDEX	NA	11.10% (1999)

Glossary

Dow Jones Industrial Average: A price-weighted index tracking thirty large industrial companies selected by the editors of *The Wall Street Journal.*

Standard & Poor's 500 Index: A broad-based market index, weighted by market capitalization, that comprises about 75% of the total market value of publicly traded US equities.

NASDAQ: The National Association of Securities Dealers Automated Quotation System is an over-the-counter trading exchange used mainly by newer, technology-oriented companies.

Russell 2000: The major index that tracks small capitalization stocks.

Large Capitalization Stock: Total market value of outstanding stock exceeds $5 billion.

Mid-cap stock: Between $1.5-5 billion in market capitalization.

Small-cap stock: Less than $1.5 billion market value of stock outstanding.

Growth stock: Stock of companies that, due to their strong earnings potential, offer above-average prospects for capital appreciation, with less emphasis on dividend income.

Value stock: Stocks that, considering a company's assets and earnings history, are attractively priced relative to current market standards of price-to-earnings ratios, price-to-book ratios, et al. They typically pay regular dividends to shareholders.

Price/Earnings Ratio: Sometimes referred to as the "multiple", the P/E Ratio is the stock price divided by the company's net income per share over the past twelve months.

Treasury yield: The current market interest rate on bonds issued by the US Treasury with a specific maturity date (i.e. 30 years). Bonds are issued at a specific interest rate and at a specific price (such as 100 or "par") but the subsequent price and yield will be determined every day by prevailing market conditions. If rates generally rise (fall) after initial issuance, the price of the original bond will fall (rise) in order to make the effective yield on the bond rise (fall) to a level consistent with those on currently issued securities.

Corporate bond spread: The "spread" is the incremental yield offered by corporate bond issuers over those of US Treasury securities of similar maturity. The spread is a measure of investors' willingness to assume the extra credit risk inherent in corporate securities compared to virtually riskless US Treasuries.

Federal Funds Rate: The rate at which reserve funds ($1 million or more) are traded among commercial banks on an overnight basis.

High-yield ("junk") bonds: Bonds rated below investment grade issued by corporations whose overall business or financial condition is relatively weak or risky. These bonds react less to general interest rate trends than do investment grade securities.